Why You Should Ignore Monday's Stock Market Rout

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Frankly, 2015 was a rough year for investors. Hedge funds recorded their seventh consecutive year of underperforming the S&P 500. Even Warren Buffett's Berkshire Hathaway (NYSE:BRK.A) (NYSE:BRK.B) tumbled by just over 12%, dragged down by underperforming investments in IBM (NYSE:IBM), American Express (NYSE:AXP) and plummeting profits in Berkshire's insurance business.

By some measures, 2015 was the hardest year to make money in 78 years. While 2008 saw a collapse in global stock markets, at least you could make money in fixed income or currencies. In 2015, nothing really worked. And with the S&P 500 off to its worst New Year's start since 2001, 2016 is hardly looking much better. This time, it was a market hiccup from China, which caused global stock markets to fall like dominos on the first trading day of the New Year.

The phones of perennial doom-and-gloomers like Marc Faber, Nouriel Roubini and Jim Rogers are ringing off the hook, as financial TV producers book them for interviews on why the global financial system is about to implode. Heck, if it gets really bad, even Robert Prechter may put in an appearance, predicting Dow 1,000 yet again.

Why You Don't Need To Suffer

At times like this, a long-term perspective is key. Let's take the case of my favorite investment client: my son, Victor Vardy. Victor is 18 months old and has (for his age) a sizable portfolio of volatile U.S. small-cap stocks in his 529 college savings plan. His portfolio sold off sharply yesterday, falling 2.37%.

How did he react? With the indifferent serenity of a highly-trained Buddhist monk. Not only did Victor fail to allow the market sell-off to disturb his trance-like examination of my electric toothbrush, but also he didn't even notice it. Putting it in investment terms, Victor's time horizon is long.

As he will not enter college until around 2032, he doesn't need to take money out of his account tomorrow. Indifferent to the global financial market's gyrations, Victor has faith that there will be milk in his bottle and a dry, safe crib waiting for him tonight. So what is Victor's secret? He doesn't play the game. In fact, he doesn't even know that he is playing.

The Secret To Happy Investing

Of course, you would have to work long and hard to lose awareness of the stock market, which Victor doesn't even know exists. But here's a rule of thumb that can help. Look at your portfolio only once a year, say, on New Year's Eve.

Psychological studies have shown that every "red" (down) number on your screen is three times as painful as the pleasure you get from a "green" (up) number. And the more often you look at your portfolio, the more often you will see red. And seeing red hurts, literally.

Say you had only looked at your portfolio - consisting of an S&P 500 index fund - once a year since 1995, that period is not an easy one, as it includes both the post-dotcom meltdown in 2000 and the financial crisis of 2008.

If you include dividend reinvestment, the S&P 500 actually returned 1.19% in 2015, yet another positive year. The most challenging time psychologically was not the Great Recession, it was the three-year period of 2000, 2001 and 2002 when the S&P closed down 9.11%, 11.89% and 22.10% for three consecutive years.

Still, it turns out that between 1995 and 2015, the S&P 500 closed in the red only four times out of 21. So, if you'd looked at your portfolio only on Dec. 31, you'd be one happy investor, with winning years outnumbering losing years by over 5 to 1.

In The Long Run, We're All Dead

The economist John Maynard Keynes was dismissive of the "long run." Still, looking at the long run can give you some peace of mind. As the chart above confirms, the 5-, 10- and 15-year annualized returns of the S&P 500 have plummeted, especially compared to the go-go 1990s when the S&P 500 was up at least 20% for five straight years.

Still, the dotcom bust and Great Recession notwithstanding, the 20- and 25-year annualized returns on the S&P 500 are still very near double-digit percentage gains - 9.85% for 20 years and 9.62% for 25 years.

By way of comparison, the annualized return for the S&P 500 Index (and its predecessor S&P 90 Index) between 1926 and 2014 was about 10.12%. So today's long-term returns are not that far off from historical averages. And, if you consider that low inflation has boosted real returns, the picture looks even better.

The bottom line? Most things on planet Earth revert to the mean over time. Long-term investment returns on the S&P 500 are one of those things. The S&P 500 has returned roughly 10% annually over the course of the past 90 years. It is likely to return that same 10% over the course of the next 90 years, as well.